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Multilateral processes for managing sovereign external debt

Development strategies in a globalized world: Multilateral processes for managing sovereign external debt

Note by the UNCTAD secretariat

Executive summary

The present document summarizes the main aspects of the analysis of the external debt situation of developing countries and countries with economies in transition, as presented in chapter V of the forthcoming *Trade and Development Report 2015*. It provides a brief overview of the core issues in the external debt of developing countries, and reviews the main trends in the evolution of external debt indicators and composition. It then analyses the underlying causes of the debt crises of developing countries in the world economy today, and discusses essential features and limitations of the current fragmented system of sovereign debt restructuring. Finally, it discusses different proposals to enhance sovereign debt restructuring mechanisms, in particular a multilaterally based statutory approach.

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I. External debt: Main issues

1. The present document addresses a long-standing deficiency in the international monetary and financial system, namely the lack of an effective mechanism to help better manage external debt crises. It pays particular attention to sovereign debt since, even when financial crises originate in the private sector, as often occurs, they usually result in public overindebtedness and a prolonged period of economic and social distress. Estimates vary, though a recent paper by the International Monetary Fund (IMF) found that such a crisis had eliminated 5 to 10 percentage points from current growth figures and that after eight years, output was still lower than country trends by some 10 per cent.[1] International awareness of the need to consider more effective approaches to sovereign debt resolution has grown in recent years, as evidenced by a series of United Nations conferences and resolutions.[2]

2. In the last eight major crises in emerging economies (beginning with Mexico in 1994, followed by Thailand, Indonesia, the Republic of Korea, the Russian Federation, Brazil, Turkey and, finally, Argentina, in 2001), a significant proportion of the private debt, both domestic and external, was socialized through Government bailouts, often through a recapitalization of insolvent banks, which increased sovereign debt levels. Much the same pattern has been repeated in Ireland and Spain during the recent crisis in the eurozone.

3. External debt is not a problem in itself. Indeed, debt instruments are an important element of any financing strategy. Yet it can easily become a problem when foreign borrowing is unrelated to productive investment, or when a net debtor country is hit by a severe external shock that undermines its capacity to repay its debt. In such circumstances, the claims on a debtor can quickly exceed its ability to generate the required resources. If these claims are not matched by new credit inflows, servicing the external debt amounts to a transfer of resources to the rest of the world, which, if significant, will reduce domestic spending and growth in the debtor country. This, in turn, may eventually affect the country's ability to make payments when they fall due.

4. High levels of external debt have diverse causes and dissimilar impacts in different groups of economies. In most low-income countries, they are the result of chronic current account deficits, primarily reflecting limited export capacities and a high degree of dependence on imports for both consumption and investment purposes. Most of the capital inflows that have had a direct debt-generating effect on these economies have come from official sources. By contrast, in several middle-income countries that are much more integrated into the international financial system, a core driver of the accumulation of large stocks of external debt has been their increasingly easy access to international financial markets and private creditors since the mid-1970s. A significant proportion of the private capital flows to these countries exceeded those required to finance current account deficits and ended up as residents' private capital outflows or reserve accumulation by a central bank.

5. The sustainability of an external debt burden depends on the relationship between the growth of domestic income and export earnings, as well as on the average interest rate and maturity profile of the debt stock. Thus, to the extent that foreign capital inflows are used for expanding production capacities, they contribute to boosting domestic income and export earnings that are required to service the debt. However, where external debt primarily results from large surges in private capital inflows relative to a country's gross

[1] D Furceri and A Zdzienicka, 2011, How costly are debt crises? Working Paper 11/280, IMF.

[2] See for example General Assembly resolutions 64/191, 65/144, 66/189, 67/198, 68/202 and 68/304.

domestic product and if those inflows are unrelated to current needs for the financing of trade and investment, they can lead to asset bubbles, currency overvaluation, superfluous imports and macroeconomic instability, thereby increasing the risk of default.

6. The sustainability of external debt also depends on its structure and composition. The commonly used definition of gross external debt (including in the present document) adopts the residence criterion, which refers to non-resident claims on the resources of the debtor economy. Other criteria used to distinguish between domestic and external debt are whether the debt is denominated in domestic or foreign currency and the jurisdiction under which the debt is issued. When most external debt consisted of loans, the criteria of residence, currency and jurisdiction tended to coincide (i.e. the lender was non-resident and the loan was issued in a foreign currency under foreign law). This has changed significantly since the early 1990s. Over the past two decades, increases in the stock of outstanding debt have been accompanied by a shift in debt instruments from syndicated bank loans to more liquid bond debt. Since bonds issued in a local currency and under local law may be held by foreign investors and, conversely, sovereign debt denominated in foreign currency may be held by residents, there is a share of debt that may be considered external under some criteria and domestic under others.

7. The amount of debt that has been issued in foreign currencies will significantly affect debt sustainability. This is because, in order to service such debt, a debtor must not only generate the required income but also obtain the corresponding foreign exchange. This depends on the state of a country's balance of payments. However, it can also produce a significant policy dilemma, whereby domestic currency devaluations and tight macroeconomic policies, while intended to improve export performance, will also increase the real value of the foreign denominated debt and reduce the debtor's income.

8. In mostly higher income developing countries, a recent trend has been a shift in the denomination of external debt from foreign currency to local currency. This has been made possible largely as a result of a strong expansion of global liquidity and concomitant surges of capital inflows into these economies, reflecting the willingness of lenders to assume the exchange rate risk. Yet the residence criterion remains relevant for debt sustainability, as investments in local bonds and securities by non-residents make domestic debt markets more liquid. Moreover, growing non-resident participation in these markets also means less stability in holdings relative to participation by domestic institutional investors, as the latter are usually subject to regulations that oblige them to hold a given percentage of their assets in local debt instruments. The decision by non-resident creditors to liquidate their local currency denominated debt and repatriate their earnings could weigh heavily on the host country's balance of payments.

9. Finally, the jurisdiction of debt issuance affects debt sustainability, since it defines the rules under which any dispute between debtors and creditors will be negotiated, such as the extent to which non-cooperative creditors will be allowed to disrupt State–private creditor majority agreements on debt resolution. More generally, if the external debt of developing countries has mostly been issued under foreign jurisdictions as a supplementary guarantee for investors that are distrustful of the judicial system of the debtor country, this has the potential to complicate crisis situations, since the debtor economy may have to contend with multiple jurisdictions and legal frameworks.

10. Sovereign debt deserves special attention for a number of reasons. In some instances, Governments may encounter difficulties in servicing the external debts they have incurred to finance their public expenditures. In many other instances, however, the initial cause of a sovereign debt crisis is the imprudent behaviour of private agents, on the side of both borrowers and creditors. In principle, a private debtor's defaults on its external debt fall under the insolvency law of the jurisdiction in which the debt was incurred. This legal framework typically provides for a certain degree of debtor protection and debt

restructuring (with or without a partial debt write-off) or for a debtor's bankruptcy and subsequent liquidation of its assets. Yet when a series of private defaults threatens to disrupt the financial system, the public sector often assumes private debt, especially that of large banks, and as a consequence becomes overindebted itself.

11. However, sovereign debt problems are not subject to the legislation that governs private defaults. They therefore necessitate specific treatment, not least because they often have significant social, economic and political impacts. This raises the question of how best to approach sovereign debt restructuring in an increasingly globalized economy, which is addressed in chapter IV of the present document.

II. External debt: Main trends in volume and composition

A. Total external debt in developing countries and countries with economies in transition

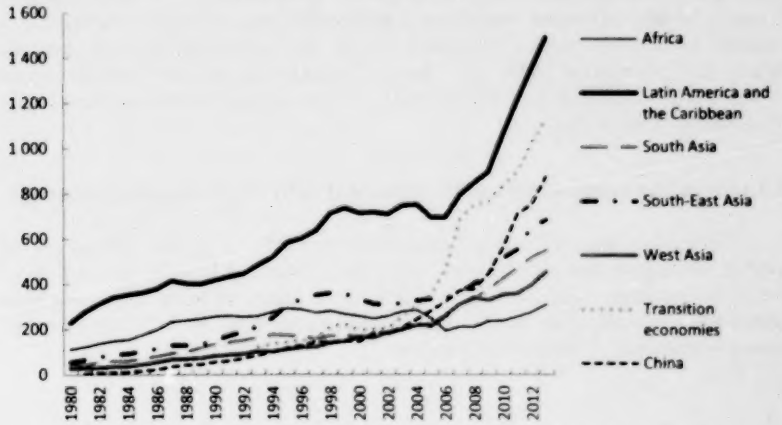
12. Measured in nominal terms (and according to the residence criterion), the external debt of developing countries and countries with economies in transition has displayed a rising trend in the long term. With the exception of Africa, which remained a less attractive market for private investors and greatly benefited from debt reduction programmes, all other regions exhibited a significantly higher debt stock by mid-2015 than in the 1990s (figure 1). This was not a steady trend, however. Latin America and South-East Asia – the two developing regions most integrated into the international financial system – had relatively more stable external debt levels between 1997–1998 and 2006–2007. This was the result of their own debt crises in the second half of the 1990s, which created a temporary restriction on their access to new private foreign credit. Yet it was also partly due to their subsequent efforts to reduce their dependence on capital inflows by avoiding recurrent current account deficits or even generating significant surpluses. This trend was again reversed with the global financial crisis in 2008, not least due to renewed high inflows of foreign capital driven by expansionary monetary policies in developed countries.

13. Measured as a share of gross domestic product or gross national income, external debt declined at varying rates in all developing regions from the late 1990s until the crisis in 2008 (figure 2). Thereafter, this debt ratio started to rise again. The reduction in the ratio of external debt to gross national income that developing countries and countries with economies in transition experienced in the years prior to the crisis was due to their robust economic growth, often coupled with real exchange rate appreciations that further raised the current dollar value of their gross national incomes.

14. In China and South Asia, the ratio of total external debt to gross national income declined steadily between 1993 and the mid-2000s, despite a non-negligible increase in their nominal external debt, albeit from low values. This was largely due to their very rapid economic growth. In China, this trend was reinforced by a shift from external to domestic borrowing. Other developing and transition regions have experienced significant fluctuations in external debt ratios since 1990, due to successive waves of capital inflows interrupted by financial crises.

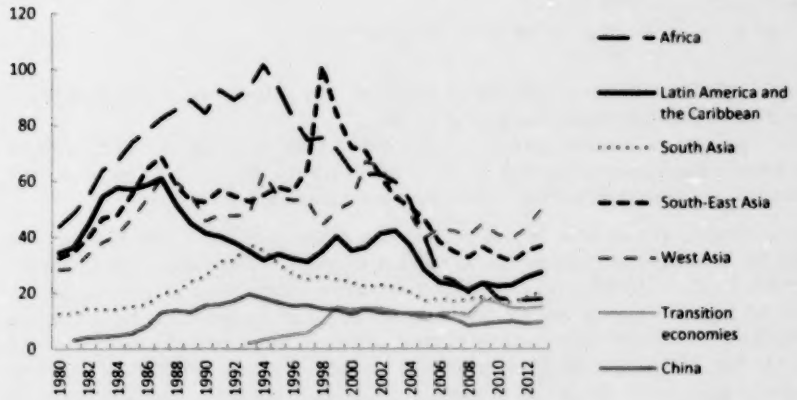
15. The most significant reduction in the ratio of external debt to gross national income occurred in Africa, where it fell, on average, from more than 110 per cent in 1994 to below 20 per cent in 2013 (figure 2). In addition to growth acceleration in the 2000s, this region benefited more than any other from official debt relief programmes. This largely explains the diminishing weight of interest payments as a share of exports in this region from, on average, 13 per cent during the 1980s to around 1 per cent in 2012–2013. Other regions also saw a significant reduction over the same period.

Figure 1
External debt in selected country groups and China, 1980–2013
(Billions of current dollars)



Source: UNCTAD secretariat calculations, based on the World Bank World Development Indicators database and national sources.
Note: Aggregates are based on countries for which there is a full set of data since 1980, except for countries with economies in transition, for which data is available from 1993.

Figure 2
External debt stock as a proportion of gross national income, selected country groups and China, 1980–2013
(Percentage)



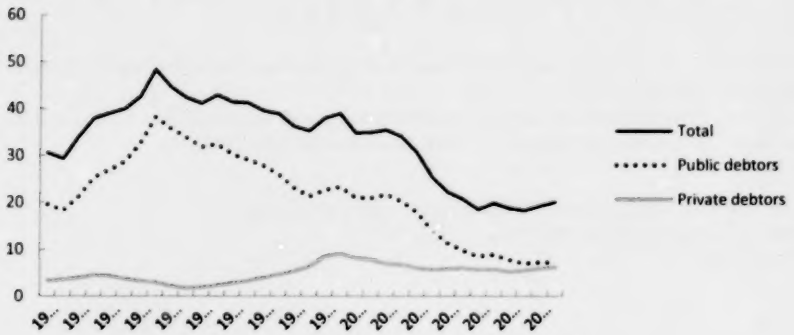
Source: UNCTAD secretariat calculations, based on UNCTADstat, the World Bank World Development Indicators database and national sources.
Note: Aggregates are based on countries for which there is a full set of data since 1980, except for countries with economies in transition, for which data is available from 1993.

16. While external debt ratios have been rising again, albeit slowly, since the late 2010s, historically low to moderate levels of the ratio, combined with overall falling interest payments on external debt since the late 1990s, might convey an impression of

macroeconomic robustness and stability. Yet such an outlook is premature. Recent episodes of turmoil in international financial markets – triggered by expectations of a winding down of quantitative easing in the United States of America and a normalization of interest rates in the country – have affected emerging economies.[3] More generally, the recent excessive increase in liquidity in international financial markets that remains largely unconnected to long-term development finance, increasing foreign participation in growing domestic markets for Government debt, and foreign currency denominated private sector indebtedness, all combine to increase the exposure of developing countries to the volatility of international financial markets.

B. Changes in the composition of the external debt of developing countries

17. The relative share of external debt owed by public or private debtors has an important bearing on debt sustainability.[4] Historically, public debt made up the bulk of external debt in developing countries. In 2000, for example, its share in the long-term external debt stocks of all developing countries was 72 per cent. By 2013, this share had declined to nearly half of the total stocks (figure 3).



Source: UNCTAD secretariat calculations, based on UNCTADstat, the World Bank World Development Indicators database and national sources.

Note: Aggregates are based on countries for which there is a full set of data since 1980, except for countries with economies in transition, for which data is available from 1993. As part of the total external debt is unspecified, public and private debts do not always add up to the total

18. External private debt, by contrast, was historically quite limited and thus attracted little attention from oversight bodies. In addition, oversight bodies tended to be influenced by free market advocates who opposed Government intervention in growing private external liabilities, on the grounds that these resulted from the actions of rational agents with respect to private saving and investment-related decisions, and therefore would not lead to financial distress. However, experience – particularly in the aftermath of the global financial crisis when high levels of external private debt became a significant driver of public sector debt crises – has challenged the validity of such an approach. Policymakers should therefore not be too complacent about the overall lower levels of public debt in many developing economies. Rather, they should be wary of the significant risks to

[3] See UNCTAD, 2014, The recent turmoil in emerging economies, Policy Brief No. 29.

[4] In the present document, public debt includes publicly guaranteed private debt and private debt only refers to non-publicly guaranteed private debt, following the classifications used for the international debt statistics of the World Bank.

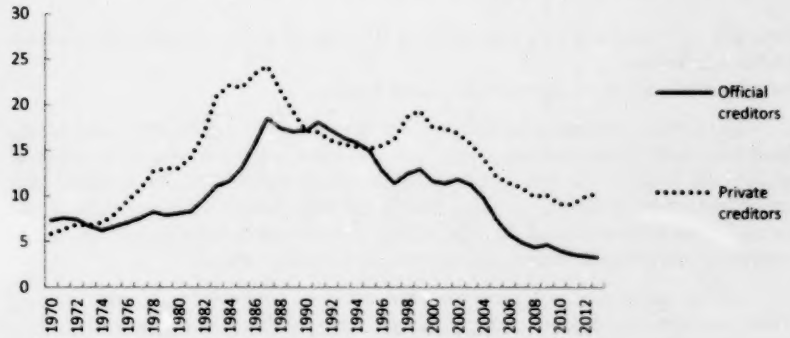
financial stability associated with the increasing ratios of private external debt to gross national income (figure 3). This includes rising levels of private external borrowing by non-financial corporations over the past few years, primarily for purposes of financial operations via the offshore issuance of debt securities.[5] It is compounded by exchange rate risks and the danger of sudden reversals of capital flows, for example in the wake of a normalization of United States interest rates and/or volatile commodity prices.

19. The structure of external debt has also evolved significantly on the side of creditors. In most developing countries, until the 1970s and sometimes in subsequent decades, a large proportion of long-term external debt was owed to official creditors mostly on a bilateral basis. In the early 1970s, in all regions other than Latin America, official external debt outpaced that owed to private creditors (figure 4). In recent years, the share of official debt in developing and emerging economies has remained below 20 per cent of the total external debt.[6]

Figure 4

Long-term external debt by type of creditor in developing countries, 1970–2013

(Percentage of gross national income)



Source: UNCTAD secretariat calculations, based on UNCTADstat and the World Bank International Debt Statistics database.

Note: Data refer to all year-end disbursed and outstanding debt.

20. The 1970s saw a sharp rise in the external debt of developing countries, largely due to Latin American borrowers, and with this a strong increase in debt owed to private creditors. Such debt, mostly in the form of syndicated bank loans, rose from 5 per cent of the gross national income of developing countries in 1970 to 12 per cent in 1980. Following the Volcker shock in 1979 and the Latin American debt crisis, a large share of this debt was transferred to the public sector. Similarly, prior to the Asian financial crisis of 1997, a significant proportion of the debt incurred in the region was in the form of bank loans to private borrowers that were de facto nationalized after the onset of the crisis. The Latin American debt crisis eventually saw private-debt-turned-public-debt replaced with Brady bonds. Most restructurings involving Brady bonds included the exchange of bank loans for bonds of either equal face value (but with a fixed and below market rate of interest) or lesser face value. The plan thus initiated a process of financial disintermediation, that is of

[5] See S Avdjiev, M Chui and HS Shin, 2014, Non-financial corporations from emerging market economies and capital flows, *Bank for International Settlements Quarterly Review*, 4:67–77.

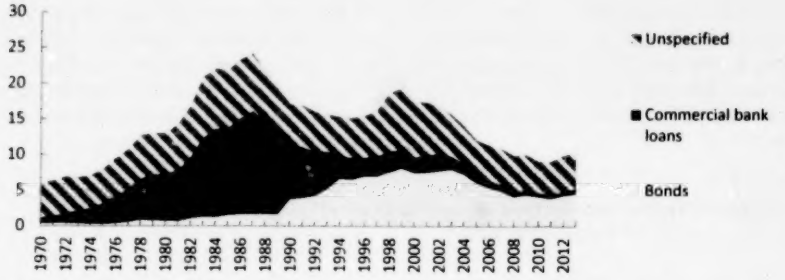
[6] Y Akyüz, 2014, Internationalization of finance and changing vulnerabilities in emerging and developing economies, UNCTAD Discussion Paper No. 217.

more direct borrowing from capital markets via bonds instead of borrowing from commercial banks. This has been on an accelerating trend ever since (figure 5).

Figure 5

Long-term external debt of developing countries owed to private creditors, by type of debt, 1970–2013

(Percentage of gross national income)



Source: UNCTAD secretariat calculations, based on UNCTADstat and the World Bank International Debt Statistics database.

Note: Data refer to all year-end disbursed and outstanding debt.

21. The currency denomination of external debt significantly affects debt sustainability mainly because of the associated exchange rate risk, whereby a devaluation of the domestic currency will increase the real value of foreign denominated debt. By contrast, local currency debt reduces the risk resulting from a currency mismatch between debt on one hand and assets and revenues on the other. Moreover, in the latter instance, it is possible for the national central bank to intervene if an emergency situation arises.

22. Consequently, a growing number of developing economies have been shifting towards local currency denominated debt. Nevertheless, the drawbacks of foreign currency denominated debt remain a relevant issue, since a large proportion of the gross external debt of developing countries is still in the form of bank loans and official debt, and thus denominated in foreign currency. This occurs particularly in poorer developing countries with small domestic debt markets, a heavy dependence on official lending and low credit ratings, but also in some larger middle-income developing countries and countries with economies in transition. For example, in 2013, the share of external debt denominated in foreign currency was 95 per cent in Argentina, 93 per cent in Turkey, 80 per cent in India, 74 per cent in the Russian Federation, 70 per cent in the Republic of Korea and 64 per cent in Mexico.

23. Finally, the jurisdiction under which debt is issued is relevant once a default arises, because it defines the courts and the legislation under which a debt contract, and thus the process of debt restructuring, will ultimately be regulated. One study noted that in recent years, almost 50 per cent of sovereign defaults involved legal disputes abroad, compared with 5 per cent in the 1980s, and that 75 per cent of such litigation involved distressed debt funds, also known as vulture funds.[7]

[7] J Schumacher, C Trebesch and H Enderlein, 2014, Sovereign defaults in court, Social Science Research Network, available at: http://ssrn.com/abstract=2189997 (accessed 5 August 2015).

III. External debt crises and debt resolution

A. External debt crises: Main features

24. While the structural causes of developing country debt crises vary, recent crises have been closely linked to the rapid liberalization of financial markets, the intrinsic instabilities of these markets and the global financial cycles they have produced over the past few decades.[8] Generally speaking, debt crises occur at specific junctures in financial cycles. They start when a significant number of debtors (or some large ones) are no longer able to service debt accumulated during an expansionary phase. As a result, risk perception shifts from overconfidence to extreme unease, leading to liquidity shortages, asset price collapses and an economic downturn. Eventual asset liquidations further depress the price of assets, in particular of those assets that were the primary object of speculation during the boom period and served as a guarantee for the debt. This not only causes the bankruptcy of highly indebted agents, but also affects more prudent agents who would be solvent in normal times. Once a debt crisis occurs, a potentially long process of financial consolidation must take place before the economy can begin to recover, lending can resume and an eventual exit from the crisis can be achieved.

25. The specificities of external debt, as discussed in chapter II, tend to increase the vulnerabilities associated with financial cycles. In many developing economies today, their increased openness to international financial markets is the main driver of the build-up of external debt and their concomitant exposure to high levels of risk of macroeconomic instability. In theory, openness to capital flows can have a countercyclical effect by allowing developing countries to borrow during economic slowdowns and repay during expansions. Yet this would require capital flows to respond passively to the demand from developing countries, and their use effectively for countercyclical purposes. In reality, push factors in developed economies, such as their monetary policies, risk perceptions and the leverage cycles of their banks, are often the driving forces. Indeed, all major waves of capital flows to developing countries since the mid-1970s have been prompted by expansionary monetary policies aimed at mitigating economic recessions in key developed countries.[9] With limited credit demand and low interest rates in their own markets, financial institutions from developed countries have channelled part of their credit to developing or emerging economies in search of higher yields. These flows have frequently exceeded the amount that most developing countries could use productively.

26. Very high capital inflows entering relatively small economies have thus tended to generate domestic credit booms, strong asset price increases and currency appreciations. They have also facilitated sizeable imports of consumer goods and services, leading to current account deficits and indebtedness, particularly in the private sector. When economic conditions and risk perception in developed countries change or indebted developing countries experience repayment difficulties, capital movements can reverse suddenly and trigger external debt crises. Steep currency depreciations increase the value of external debt in the domestic currency, resulting in insolvency for those agents whose incomes are mainly denominated in the domestic currency and whose external liabilities are not matched by external assets. Widespread bankruptcies affecting the real and financial sectors of the economy typically prompt public sector interventions to contain the crisis, including through bailouts, emergency financing and countercyclical measures. As a result, external

[8] See UNCTAD, 2014, and Y Akyüz, 2012, The boom in capital flows to developing countries: Will it go bust again? *Ekonomi-tek*, 1(1): 63–96.

[9] Akyüz, 2012.

debt crises are often also fiscal crises, even where Governments have not engaged in extensive foreign borrowing during the boom period.

27. Private external debt defaults do not pose a specific problem; so long as the debt does not systematically affect the wider economy, managing private defaults only requires applying commercial law in the jurisdiction in which the debt was issued. By contrast, sovereign external debt problems present particular features that, in the event of a default, require specific arrangements to manage. The systemic issues raised by sovereign debt and default, and the legal and economic challenges they pose, are addressed in subsection B.

B. The existing system of sovereign debt restructuring: Main features and limitations

28. Given the considerable vulnerability of the financialized global economy to socially, politically and economically costly debt crises, national and international policymakers require appropriate instruments to handle crises in a way that minimizes such costs. In principle, debt resolution mechanisms should help prevent impending financial or debt crises when countries face difficulties in meeting their external obligations. They should pre-empt any sudden collapse of market confidence that has potentially catastrophic long-term consequences for the debtor economy. At the same time, such mechanisms should aim at a fair distribution of the burden of debt restructuring between debtors and creditors. Finally, they should respect national sovereignty and preserve domestic policy space in order to allow a debtor economy to grow, achieve improved debt sustainability and design and implement its own development strategies.

29. The current system of sovereign debt restructuring is highly fragmented and based on a range of ad hoc arrangements covering different procedures for different kinds of external sovereign debt.

30. The Paris Club, founded in the 1950s, provides the main negotiating forum for restructuring the official bilateral debt of its member States. Negotiations cover medium and long-term debt, including export credits whose terms exceed one year. For many years, the Paris Club did not consider debt sustainability to be a concern and excluded debt relief from its agenda. This changed in the late 1980s, when it began to consider special treatment for the debt of poor countries owed to official creditors. The terms offered to poor countries (Toronto terms, London terms, Naples terms and Cologne terms) have undergone a number of changes since then, culminating in the Evian terms in 2003, which also introduced explicit considerations of debt sustainability indicators (see http://www.clubdeparis.org/sections/types-traitement/reechelonnement).

31. Multilateral institutions continue to play a key role in sovereign debt resolution, despite the fact that multilateral debts have generally been exempted from debt restructuring or relief. The involvement of IMF, the World Bank and multilateral development banks typically consists of providing exceptional financial assistance when voluntary private financing ceases or is no longer available. Consequently, these institutions have benefited from becoming preferred creditors. Their financing has often been conditional upon strict and comprehensive policy requirements originally intended to ensure that countries would be able to redress their imbalances and repay their loans. Therefore, securing a credit agreement with these institutions (particularly IMF) has generally been a precondition to negotiating debt restructuring or relief with other creditors.

32. The main exception to the rule that exempts multilateral debt from restructuring is the debt owed by poor countries, mainly through the Heavily Indebted Poor Countries Initiative launched in 1996 and enhanced in 1999. The original initiative was intended to provide the poorest countries with an exit from the repeated debt rescheduling process. In

June 2005, to supplement the multilateral debt relief under the Heavily Indebted Poor Countries Initiative, the Group of Eight proposed a Multilateral Debt Relief Initiative. This initiative provided for 100 per cent relief of the debt owed to IMF, the World Bank and the African Development Bank, as well as the International Development Association and the African Development Fund.

33. Overall debt restructuring with official creditors thus follows a pre-established procedure with little room for negotiation. This is in contrast to the treatment of sovereign debt with private creditors, which consists of bank loans and external bonds. Bank loans are subject to negotiations at the London Club, an informal group of international commercial banks established in 1976. When a sovereign debtor requests debt restructuring, a bank advisory committee is created through the London Club process, chaired by a lead bank whose main task is to coordinate the bargaining position of the creditors. Since the London Club does not establish binding resolutions or have defined voting procedures, agreements have sometimes required lengthy negotiations and free riders have posed a recurrent problem. Although the negotiation process allows considerable flexibility within the private law paradigm, it has maintained some links with negotiations on official bilateral and multilateral debt. For example, reaching a credit agreement with IMF is a de facto requirement for a Government seeking to restructure its debt with the London Club and, reciprocally, avoiding arrears in payments with private banks is a usual condition for signing an agreement with IMF. With regard to Paris Club agreements, commercial banks are normally asked to offer comparable treatment (i.e. debt relief) to that offered by official creditors.

34. The substantial shift from syndicated bank loans to external bond financing over the past two decades has significantly increased the complexity of debt restructuring. Thousands of bondholders with diverse interests may be faced with divergent regulatory constraints and bond series may be issued in different jurisdictions. Usually, informal negotiations with separate groups of bondholders take place before a debtor country eventually proposes bond swaps with lower face values, longer maturities and/or lower interest rates. Other basic characteristics of the bonds may also be altered; new bonds may be denominated in a different currency, may be subject to a different jurisdiction and may incorporate new clauses, such as collective action clauses. Bondholders then vote for or against accepting the swaps. If the original bonds included collective action clauses, a qualified majority may make the vote binding on all bondholders. If no such clauses were included or the required majority is not attained, creditors that have not accepted the swap (holdout bondholders or holdouts) may seek better terms or even full repayment through litigation. Increasingly, conventional bondholders are being replaced by specialized investors (including vulture funds) that are not interested in reaching a settlement but instead are seeking to obtain full payment through litigation.

35. This fragmented restructuring system for sovereign debt presents a number of risks and limitations, as detailed in the following subsections.

1. Too little, too late

36. It appears under the current system that neither debtor Governments nor creditors have an incentive to recognize a situation of overindebtedness and take early and comprehensive action.[10] For debtor Governments, a major disincentive is the likelihood that declaring a debt moratorium will have a self-fulfilling effect by triggering an economic crisis. Furthermore, defaulting too early may be viewed by creditors as a strategic and

[10] LC Buchheit, A Gelpern, M Gulati, U Panizza, B Weder di Mauro and J Zettelmeyer, 2013, *Revisiting sovereign bankruptcy – Committee on International Economic Policy and Reform* (Brookings Institution, Washington, D.C.).

avoidable default aimed at lower debt servicing. Governments may wish to avoid the consequent reputational costs, which would result in lower access to credit. Creditors also have an interest in delaying explicit recognition of a solvency crisis, as opposed to a mere liquidity crisis, since, in the event of a solvency problem, no creditors can expect to recover their loans in full (except, to some extent, multilateral institutions with preferred creditor status). Private lenders therefore tend to initially minimize the extent of debt problems, a stance that has often been endorsed by IMF and other official creditors. The subsequent provision of emergency support to bridge liquidity shortages is then often used to repay private creditors that are more reluctant to renew credit lines, rather than to revive the economy.[11]

2. Asymmetric and procyclical resolution processes

37. Unlike private firms, indebted States cannot be declared bankrupt. Ultimately, debt resolution processes therefore need to focus on a debtor economy's ability to recover as quickly as possible and on minimizing social, political and economic adjustment costs in the process. This requires a supportive international framework that provides the necessary policy space for a country to conduct countercyclical policies so that the debtor economy can restore its debt servicing capacity throughout investment, output and export growth rather than import contraction, and Government debt can be reduced through increasing public revenue rather than reducing expenditure.

38. The current international financial and monetary system is lacking in this regard, and is characterized by a contractionary bias. Thus, IMF standard credits under standby agreements typically include fiscal and monetary austerity measures. Subsequent IMF programmes have introduced structural reforms in addition to conventional macroeconomic adjustments as a new form of conditionality, yet in their various manifestations they have continued to focus on strict, contradictory measures. Arguably, such conditionalities have done little, if anything, to promote debt sustainability through growth, and have mostly been counterproductive. IMF has progressively noted errors in its policy conditionalities under crisis conditions, emphasizing that fiscal austerity during recessions is more costly than was previously assumed, as fiscal multipliers are higher, the assumption of a trade-off between public and private demand is questionable and public spending cuts are not automatically offset by higher private demand.[12] IMF has also recognized that its strict conditionality and a cumbersome process for delivering credit support were inappropriate for preventing or addressing external debt crises triggered by gyrations in the capital account. However, to date, its new credit lines have not been much used and do not address the situation of the most vulnerable countries, including those hit by an external debt crisis.[13]

3. The rise of non-cooperative creditor litigation

39. The widespread promotion of creditor rights and the rapid rise of bond financing in external debt markets has facilitated the emergence of highly speculative funds run by non-cooperative bondholders, including vulture funds. Their strategy consists of buying defaulted bonds at a significant discount and then aggressively suing Governments for

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[11] To avoid such inefficient use of exceptional financing, the Articles of Agreement of IMF include a rule to the effect that "a member may not use the Fund's general resources to meet a large or sustained outflow of capital" (article VI). Since the 1980s, this rule has been repeatedly overlooked in the managing of sovereign debt crises.

[12] IMF, 2012, *World Economic Outlook* (Washington, D.C.).

[13] Colombia, Mexico and Poland have applied for the Flexible Credit Line of IMF and the former Yugoslav Republic of Macedonia and Morocco have applied for the Precautionary and Liquidity Line.

repayment of their debts at face value plus interest, arrears and litigation costs, with gains of between 200 and 3,000 per cent. Holdout litigation has been particularly disruptive in the context of multilateral debt relief efforts aimed at reducing the external debt burden of heavily indebted poor countries.[14] In practice, this kind of litigation has significantly eroded the (limited) fiscal space created by debt relief to alleviate poverty and foster economic development in these countries. At least 18 heavily indebted poor countries have been threatened with or subjected to legal actions by such creditors since 1999, leading to an (estimated) more than 50 lawsuits. The general trend by most courts to rule in favour of holdout litigator interests was recently highlighted by *Republic of Argentina v. NML Capital, Ltd.* In particular, the sitting judge interpreted the pari passu (equal treatment of all bondholders) clause as requiring Argentina to make rateable payments to all creditors. Argentina was thus no longer allowed to repay its restructured debt without simultaneously repaying NML Capital, Ltd. in full. The judgement also forbade any financial intermediary from collaborating with Argentina in paying exchange bondholders unless they were notified that the holdouts had received rateable payments. Such rulings make future debt restructurings even more difficult than they already are as they encourage creditors to not consent to debt restructuring agreements so that they can exercise more leverage to seek full repayment. In addition, those agreeing to a debt restructuring can no longer be certain they will be paid. Moreover, many such rulings show a blatant disregard for the sovereignty of the debtor, for third party interests and for the wider socioeconomic impacts they might have on a debtor economy.

4. The role of contingent liabilities in sovereign debt restructuring

40. Finally, another recent and growing area of concern deserves mention, namely the problem of contingent liabilities of a sovereign and their treatment in debt restructuring processes. Sovereign contingent liabilities refer mostly to third party debt guarantees. These are, almost by definition, not included in the public balance sheet precisely because they constitute liabilities contingent on the primary debtor's ability to service its debt. At the same time, this practice keeps the sovereign's official debt ratio low, thus facilitating its continued access to future borrowings. Preliminary evidence suggests that, since the global financial crisis, sovereign contingent liabilities have grown exponentially, though mostly in Western Europe.[15] How these growing contingent liabilities may be included in sovereign debt restructuring is currently unclear.

IV. Alternative mechanisms for debt resolution

41. Concern with the lack of a resolution mechanism for external sovereign debt is not new (see for example the annex to chapter VI of *Trade and Development Report 1986*, chapter IV of *Trade and Development Report 1998* and chapter VI of *Trade and Development Report 2008*). Since the global financial crisis, there has once again been increasing recognition for the need to facilitate sovereign debt restructuring. At present, there are broadly three types of approaches to sovereign debt restructuring mechanisms, namely a market-based approach that centres on improvements of already existing mechanisms based on contract law and a primary focus on privately held sovereign debt; a semi-institutional approach that advocates the use of soft law international principles; and a

[14] See the 2010 report of the independent expert on the effects of foreign debt and other related international financial obligations of States on the full enjoyment of all human rights, particularly economic, social and cultural rights (A/HRC/14/21).

[15] See LC Buchheit and GM Gulati, 2013, The gathering storm: Contingent liabilities in a sovereign debt restructuring, Social Science Research Network, available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2292669 (accessed 5 August 2015).

statutory approach that aims for a comprehensive multilateral treaty to define internationally binding mechanisms.

42. These proposals differ in a number of key aspects, such as which types of debt are included, the degree of coordination and centralization needed for sovereign debt restructuring mechanisms and how participatory and transparent these should be, whether or not such mechanisms should include adjudication in cases where no voluntary agreement has been reached, and how consistent various debt restructuring outcomes should be.

A. Contractual or market-based approach

43. A number of prominent proposals to facilitate sovereign debt restructuring seek to maintain the integrity of existing market-based approaches by clarifying and strengthening their legal underpinnings, in particular by improving collective action clauses. Other proposals include contingent payment provisions and the clarification of the pari passu provision in debt contracts. Contingent payment is not primarily concerned with a sovereign debt restructuring mechanism itself, but introduces the provision that future payments by sovereign debtors should be made contingent on observable economic conditions, for example via the use of gross domestic product-indexed bonds or contingent-convertible bonds.

44. The main advantage of a market-based approach is that debt restructurings remain voluntary and, at least potentially, consensual. It also allows for gradual reform, as the widespread implementation of such contractual proposals might help to promote debt sustainability and reduce uncertainty about outcomes, preparing the ground for more far-reaching reforms.

45. However, collective action clauses also have some major limitations. Conventional single-series collective action clauses, requiring a qualified majority of bondholders of every single issue to give their consent, can easily be disabled by holdout creditors who buy a blocking minority. Aggregated collective action clauses, which require a twofold qualified majority – that of the holders of each bond issue as well as of the holders of all covered bond issues – can reduce, but not eliminate, the risk of such behaviour. Yet even the best single-limb collective action clauses that do not require voting by bond issue cannot guarantee that holdouts will not find ways to block the required consent. In the end, even third-generation single-limb collective action clauses remain structurally deficient.

46. Moreover, collective action clauses only apply to bond debt, and are of little help to a debtor State that has significant outstanding multilateral, bilateral or bank debt. In addition, a permanent concern is the risk of free riders taking advantage of the lack of coordination among different categories of creditors. Collective action clauses also adopt a narrow approach to sovereign debt issues. They do not prevent crises, nor do they provide the tools necessary for the resolution of crises. Finally, collective action clauses do not guarantee that the outcomes of negotiations – which will depend on the respective bargaining powers of the parties – will be consistent with a durable solution based on a return to growth.

B. Semi-institutional approach and internationally accepted principles

47. A semi-institutional approach aims at an internationally acceptable solution for sovereign debt restructuring mechanisms and thus at a higher degree of coordination, and possibly centralization, of such mechanisms than a contractual or market-based approach. In contrast to a statutory approach, it focuses on soft law principles or guidelines contained in international public law. The General Assembly, in its resolutions on external debt

sustainability and development, has repeatedly called for the consideration of such an enhanced approach to sovereign debt restructuring mechanisms based on existing frameworks and principles, with the broad participation of creditors and debtors.[16] An example of such principles is UNCTAD's *Sovereign Debt Workouts: Going Forward – Road Map and Guide* (available from http://unctad.org/en/PublicationsLibrary/gdsddf2015misc1_en.pdf).

48. More generally, core principles under discussion include sovereignty, legitimacy (comprehensiveness, inclusiveness, predictability and ownership), impartiality (the absence of bias), transparency (institutional transparency and data transparency on debtor and creditor positions, projections underlying proposed restructurings and indicators used), good faith (fairness, honesty and trustworthiness) and sustainability (i.e. sovereign debt is sustainable if it can be serviced without seriously impairing the social and economic development of society and needs to be restructured if it cannot).

49. Proponents of this approach have developed a range of suggestions promoting the institutionalization of such general principles of debt restructuring. These include, for example, the creation of an independent oversight body for restructuring negotiations, such as a sovereign debt forum (a private organization) or a debt workout institute endorsed through a multilateral process (for the latter proposal, see the UNCTAD road map referred to in paragraph 47). Another avenue for promoting the application of general or soft law principles for sovereign debt restructuring mechanisms is domestic legislation, for example the Debt Relief (Developing Countries) Act 2010 in the United Kingdom of Great Britain and Northern Ireland, which addresses problems arising from non-cooperative bondholder litigation. Similarly, in June 2015, the Belgian Federal Parliament passed a law on the fight against the activities of vulture funds, intended to curtail harmful speculation by such funds (available from www.dekamer.be/kvvcr/showpage.cfm?section=/flwb&language=fr&cfm=/site/wwwcfm/flwb/flwbn.cfm?legislist=legisnr&dossierID=1057).

50. Overall, a semi-institutional approach based on soft law yet rooted in international public law has the advantage of building, for the most part, on existing mechanisms of negotiation and restructuring. Such an approach could be scaled up in the future if it attracted enough parties. However, the main limitation of the contractual approach applies to this approach as well, if to a lesser degree, namely that the principles are not binding and there is no guarantee of the willingness of a critical mass of parties to make more permanent commitments to these principles. This problem can only be solved through a full-fledged multilateral and statutory approach.

C. Statutory approach

51. In September 2014, the General Assembly, in its resolution 68/304, decided to elaborate and adopt a "multilateral legal framework for sovereign debt restructuring processes". This represented a first step towards an international formal and statutory approach to establishing binding regulations for all parties through a multilateral process. This approach is certainly the most far-reaching and the most challenging.

52. Advocates of multilateral debt workout procedures often draw attention to the asymmetry between strong national bankruptcy laws, as an integral part of a healthy market economy, and the absence of any counterpart to deal with sovereign debt restructuring. Given the unique role of sovereign actors with respect to economic, legal and political outcomes, any such procedure should meet two objectives. First, it should help prevent financial meltdown in countries facing difficulties servicing their external obligations,

[16] See General Assembly resolutions 64/191, 65/144, 66/189, 67/198 and 68/304.

which often results in a loss of market confidence, currency collapse and drastic interest rate hikes. All of this inflicts serious damage on public and private balance sheets and leads to large losses in output and employment, as well as a sharp increase in poverty. Second, it should provide mechanisms to facilitate an equitable restructuring of debt that can no longer be serviced according to the original contract. Meeting these goals implies the application of a few simple steps, as follows:

(a) Allowing a temporary standstill, whether debt is public or private, and regardless of whether the servicing difficulties are due to solvency or liquidity. To avoid conflicts of interest, a standstill should be decided unilaterally by the debtor country and sanctioned by an independent panel. The sanction should provide an automatic stay on creditor litigation.

(b) Accompanying a standstill with exchange controls, including the suspension of convertibility for foreign currency deposits and other assets held by both residents and non-residents.

(c) Providing debtor-in-possession financing, which automatically grants seniority status to debt contracted after the imposition of the standstill. IMF should lend into arrears for financing vital current account transactions.

(d) Ensuring that debt restructuring, including rollovers and write-offs, is based on negotiations between the debtor and creditors, and that it is facilitated by the introduction of automatic rollover and collective action clauses in debt contracts.

53. There are currently two main proposals for a formal statutory approach that could achieve these objectives. The first envisages the development, in some form, of a sovereign debt restructuring facility under the auspices of IMF. This would require an amendment to the Articles of Agreement of IMF. The second proposal emphasizes the need for a more permanent and impartial international institution that is not itself implicated in sovereign lending. It also favours the establishment of an independent tribunal, whether housed in existing courts, such as the Permanent Court of Arbitration or the International Court of Justice, or newly established. In any case, any permanent institution would need to be established through a multilateral treaty (or relevant modification of an existing treaty).

54. There are some essential features shared by all of the proposals for a statutory approach to sovereign debt restructuring, namely that legal decision-making in debt restructuring cases would be governed by a body of international law agreed to in advance as part of the international debt workout mechanism; the core purpose of any sovereign debt restructuring facility or tribunal would be to provide transparent, predictable, fair and effective debt resolution; and its decisions would be binding on all parties as well as universally enforceable.

55. Establishing a statutory solution for debt restructuring would be an extremely challenging and lengthy process, from treaty negotiations to eventual ratification. To be effective, a statutory approach would need the agreement of a critical number of future members and signatories to the underlying multilateral treaty. In particular, it would need to be approved by those economies under whose jurisdiction most external debt is currently issued. This is bound to be difficult, and there are also likely to be legitimate concerns about the powers of an international tribunal or IMF facility.

56. The main advantage of a multilateral statutory approach is that, if successfully established, it would promote a set of regulations and practices that embodied long-term objectives and principles – such as sustainable development, equity and fairness of outcomes and transparency of process – over and above particular interests. Given the deep-seated problems of accountability, partiality and lack of legitimacy that characterize many existing debt restructuring mechanisms, as well as their fragmentation, the provision

of a stable and clear institutional framework for sovereign debt restructuring could contribute to more effective debt resolution by preventing self-fulfilling destabilizing expectations and by allowing outcomes to become more predictable and consistent in debt resolution cases.

V. Conclusion

57. Recurrent external debt crises are likely to remain a major challenge to global financial governance. As noted in the present document, a major driver of this growing indebtedness is the push factor of fast-rising financial capital inflows in the context of a rapid and excessive global expansion of liquidity. Moreover, the concomitant growth of often complex and opaque financial and debt instruments, along with substantial changes in the structure and composition of the external debt of developing countries, have rendered their debt highly vulnerable to the vagaries of private financial markets in particular, and in the present global economy more generally. Even with regard to the larger and more advanced developing economies, it is not clear to what extent they are prepared to face the manifold challenges stemming from a much higher market risk exposure of their external debts, a fragmented and ad hoc system of debt restructuring mechanisms and an overall economic and institutional environment that introduces a recessionary bias to macroeconomic adjustment processes.

58. The persistent vulnerabilities and challenges posed by international financial markets therefore make it all the more important to ensure that the debate on enhanced debt restructuring mechanisms is taken seriously. The different approaches to this issue reflect wide variations in understanding of an economy's functioning and needs, as discussed in the present document, which may not be easily reconcilable. Consequently, it might be prudent to adopt a gradual approach to change in this area, proceeding from the more minimalist to more far-reaching proposals. What seems clear is that, despite its obvious difficulties in terms of political consensus building, a comprehensive, predictable, equitable and consistent framework for effective and efficient sovereign debt restructuring is indispensable. It will benefit both sovereign debtors and their creditors in the long term, with the sole exception of those focusing only on speculative litigation.